

Restrictive covenants

In this article we explore restrictive covenants, what they are, their enforceability and their use in M&A deals in the advertising and marketing industry.

Given the propensity of people to move around the industry, restrictive covenants are, along with the pricing provisions, perhaps the most well-read section of the sale and purchase agreement post deal. Buyers fear that key employee sellers will leave once the agency has been sold (or once the final payment has been made) and this can potentially have a knock-on effect with key clients also moving on. Restrictive covenants are an important tool in ensuring that doesn't happen, for a few years at least.

What is a restrictive Covenant?

A restrictive covenant is a provision designed to prevent one party to an agreement doing something that it would otherwise have been at liberty to do. They are regularly included in employment agreements (particularly for senior employees) and almost always in sale and purchase agreements, where the buyer will seek restrictive covenants from the sellers to protect the target business.

Types of restrictive covenant

There are different types of restrictive covenant, including:

- ▶ **Non-compete covenants:** which prevent a person from engaging in certain competitive activities. These covenants are usually limited to competing services/products for a specified period and within a defined geographical area. Non-competes may also extend to cover the person from setting up a new business in competition and prevent them from taking up employment with a competitor. By their nature, these are the most onerous covenants.
- ▶ **Non-solicitation covenants:** which prevent a person from soliciting the business of clients and prospective clients, and sometimes also suppliers. These can also be used to prevent a person from soliciting employees of the target business.
- ▶ **Non-dealing covenants:** which prevent a person from dealing with clients, prospective clients, and suppliers of the target business; for example, this covenant would cover the situation where a client freely approaches the

person subject to the non-dealing covenant. These covenants are broader and therefore more onerous than non-solicitation covenants.

- ▶ **Non-poaching covenants:** which prevent a person from employing, engaging, or enticing away employees of the target business. These covenants usually include assisting others (e.g., a competitive employer), but may have a carve out if the employee responds directly to a public advertisement for the role.
- ▶ **Non-disclosure covenants:** which seek to protect commercially sensitive information and privacy; these covenants may prevent a person from disclosing or stealing proprietary information, business or trade secrets, inventions or other information that may provide a competitive advantage.

Are restrictive covenants enforceable?

In England and Wales, restrictive covenants are enforceable provided that the covenant does not extend beyond what is reasonable to protect a legitimate interest. When the courts examine these provisions, they will assess the reasonableness of the restrictive covenant by reference to the circumstances that existed when the parties entered into the agreement, and will consider:

- ▶ the meaning of the restrictive covenant;
- ▶ whether the beneficiary of the restrictive covenant has a legitimate business interest that requires protection;
- ▶ whether the restrictive covenant goes only as far as necessary to protect that legitimate business interest; and
- ▶ whether the covenant is contrary to public interest or policy.

Accordingly, when negotiating restrictive covenants, to maximise their enforceability, the person seeking to benefit from the covenants should consider the above and ask the following questions in relation to the overall relationship:

- ▶ what is the person giving the covenant getting in return? The greater the reward for the person giving the covenant, the more likely it is that the courts will find that there is justification for restraining that person's activities;
- ▶ do the parties have equal bargaining power – if the person giving the restrictive covenant has substantially less bargaining power than the person seeking it, the

courts may be more inclined to find that the restrictive covenant is unreasonable;

- ▶ how long should the restrictive covenant last? Generally, the longer the time period, the harder it will be to enforce. There is no fixed duration beyond which a restrictive covenant becomes unenforceable, but there is some logic in tying it to the interest that the covenant is seeking to protect; and
- ▶ how widely drafted is the restrictive covenant? The wider the drafting, the greater the risk that the restrictive covenant will be unenforceable. A good example of this is the geographical area covered. The starting point for determining the area is usually the area covered by the business to be protected. However, it may be appropriate to widen this area, particularly where a business is in its start-up, or a growth phase and its largest market remains a projection; conversely if the person giving the covenant had nothing to do with a particular territory (notwithstanding the business has operations there) the court might take a dim view on the need for such a broad restriction.

Restrictive covenants in M&A deals

Restrictive covenants contained in a sale and purchase agreement differ from those included in employment agreements; the rationale for the distinction is that the parties to a sale and purchase agreement are generally regarded as having equal bargaining power (unlike the employer/employee relationship where there may be inequality). In England and Wales the courts recognise that restrictive covenants are often necessary to protect the target business for the buyer. Therefore, restrictive covenants contained in the sale and purchase agreements are much more likely to be enforceable, are subject to less scrutiny and are generally more onerous than those contained in employment agreements.

In sale and purchase agreements, the purpose of restrictive covenants is to restrict the ability of the seller(s) to sell their existing business and then immediately start up or join a competitor business, as doing so would devalue the goodwill of the business sold to the buyer. The extent of the concern is likely to depend on the sector and nature of the business being sold. However, in our experience of deals in the UK advertising and marketing industry, it is customary for sale and purchase agreements to contain restrictive covenants which prevent the seller(s) from:

- ▶ soliciting existing clients, prospective clients (sometimes linked to pitches) and suppliers of the target business for a specified period;
- ▶ soliciting and/or employing employees (sometimes linked to seniority and/or skill set) of the target business for a specified period; and

- ▶ competing generally with the target business within a specified area for a defined period.

In some instances, these restrictions may also extend to persons connected with the seller(s).

In many deals in the industry, some or even all of the sellers may also be employees of the target business (“**owner managers**”) and will be expected to remain with the agency after completion to ensure a smooth transition, and to transfer expertise and knowledge to the buyer. Many buyers will hope that an existing successful management team will remain at the agency for several years. The desire to keep owner managers post deal often leads to some of the sale proceeds being structured as an ‘earnout’; [further details on earnouts can be found in our article](#). As part of the deal, owner managers may be expected to sign up to new employment agreements which will also contain restrictive covenants. These covenants are likely to be much shorter in duration and be linked to termination of employment.

Overall, any owner manager in the industry selling their agency needs to consider very carefully the restrictive covenants in the sale and purchase agreement. Is the money being received enough if things don’t work out under the new ownership group and they want to leave, keeping in mind that the restrictive covenants will almost certainly prevent them from continuing with their chosen career for a period of time? The equation is often not easy to balance.



Karish Andrews
Partner

+44 (0)20 7074 8106
karish.andrews@lewissilkin.com

[Find out more](#)

 twitter.com/lewissilkin

 [linkedin.com/company/lewis-silkin](https://www.linkedin.com/company/lewis-silkin)

[lewissilkin.com](https://www.lewissilkin.com)